Nos. 20,117 - 20,119

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

MADE RITE INVESTMENT CO.,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

MADE RITE TRANSPORTATION CO.,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

MADE RITE MANUFACTURING CO.,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE
TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The findings of fact and opinion of the Tax Court (II-R. 290-261) [1] are officially reported at 41 T.C. 762, sub nom. Dillier v. Commissioner.

1/ "I-R." and "II-R." references are to Volume I and Volume II, respectively, of the record on appeal; "IIA-R." references are to the transcript of proceedings contained in Volume II-A of the record on appeal.

JURISDICTION

These petitions for review (II-R. 287-291, 295-299, 302-305) involve federal corporate income taxes. On September 27, 1961, the Commissioner of Internal Revenue mailed to the taxpayers notices of deficiency, assert the following deficiencies in income taxes (I-R. 11-16, 78-83, 143-147):

Taxpayer	Taxable Year	Deficiency
Made Rite Investment Co.	1956	$20,844.20
	1957	7,911.55
	1958	5,675.55
	1959	5,675.56
Total		$40,106.86
Made Rite Transportation Co.	1956	$17,780.94
	1957	8,732.94
	1958	5,664.95
	1959	6,879.52
Total		$39,058.35
Made Rite Manufacturing Co.	1956	$ 6,053.64
	1958	4,479.03
	1959	6,053.66
Total		$16,586.33

Within ninety days thereafter, on December 26, 1961, the taxpayers filed petitions with the Tax Court for redetermination of those deficiencies under the provisions of Section 6213 of the Internal Revenue Code of 1954. (I-R. 1-10, 67-77, 134-142.) The cases were consolidated for trial in the Tax Court. The decisions of the Tax Court were entered January 21, 1965. (II-R. 269, 276, 285-286.) The cases are brought to this Court by petitions for review filed April 12, 1965 (II-R. 287-291, 295-299, 302-305), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

QUESTIONS PRESENTED

1. Whether the finding of the Tax Court that the principal purpose for the organization of the four Made Rite corporations, rather than a single corporation, and the acquisition by the organizers of all of the stock of those corporations was to avoid federal income tax by securing the benefit of three additional corporate surtax exemptions is supported by substantial evidence in the record and is not clearly erroneous.

2. Whether the findings of the Tax Court which determined the amount of reasonable compensation paid to certain officers and employees by Made Rite Investment Company and to an officer by Made Rite Transportation Company are supported by substantial evidence in the record and are not clearly erroneous. 2/

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and Regulations involved are set forth in the Appendix, infra.

STATEMENT

The pertinent facts found by the Tax Court (II-R. 213-238), some of which were stipulated (I-R. 198-200, 201-208; IIA-R. 167-168, 173), are as follows:

The events which are the subject of this litigation involve four corporations, all organized under the laws of California. The petitioners, who will be referred to collectively as the "taxpayers", are Made Rite

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2/ The Tax Court also considered other issues involving the petitioners, including whether income reported by the Made Rite corporations during the year 1955 was actually earned by the partnership and consequently was taxable to the individual partners. The petitioners have not sought review of those determinations.

Investment Company (hereinafter referred to as "Investment"), Made Rite Transportation Company (hereinafter referred to as "Transportation"), and Made Rite Manufacturing Company (hereinafter referred to as "Manufacturing"). The fourth corporation, which participated in the litigation in the Tax Court but not on review, is Made Rite Sausage Company (hereinafter referred to as "Sausage"). The taxpayers prepared their income tax returns for the calendar years 1956 through 1959 on an accrual method of accounting and filed them with the District Director of Internal Revenue at San Francisco, California. (II-R. 213-214.) 3/

I

Principal purpose for organizing four corporations

Commencing about 1930, Joseph Dillier and others were engaged in the business of manufacturing, processing, and selling frankfurters, luncheon meats, and other sausage products, hams, and bacon as a partnership under the name of Made Rite Sausage Company (hereinafter referred to as the "partnership"). Between 1930 and 1955, the business of the partnership grew substantially; the number of employees increased from approximately 8 to approximately 200. (II-R. 214.)

Thores Johnson was employed by the partnership in 1930 as a bookkeeper; he later became office manager. In 1942, he acquired an interest in the partnership. Either at that time or at some other time prior to 1949, Clarence W. Curnow, Frank Halter, and Fred Kaelin each acquired an interest in the partnership equal to that of Johnson. In 1949, they

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3/ Sausage filed corporate income tax returns, prepared on an accrual method of accounting, for the calendar years 1956 and 1957. By a timely election, Sausage elected to report its income as a small business corporation under Subchapter S of Chapter 1 (Sections 1371-1377) of the Internal Revenue Code of 1954, and filed small business corporation returns of income for the calendar years 1958 and 1959. (II-R. 214.)

purchased additional interests from Dillier and thereafter each of the five partners owned a one-fifth interest in the partnership. The partnership was operated under written "Articles of Copartnership" dated February 26, 1949. (II-R. 215.)

After the five individuals became equal partners, their respective duties were as follows: Curnow was in charge of sales; Halter was in charge of production; Kaelin was the meat buyer and also had charge of the fresh meat operations and the maintenance of the plant and refrigeration equipment; Johnson was responsible for office and clerical functions, credit and collections, advertising, bookkeeping, purchasing of packaging supplies, and labor relations; and Dillier was the general manager of the entire operation. Beginning in 1955, Dillier took a less active role in the partnership business and his duties became advisory in nature; Johnson assumed more of the duties of general manager. The partnership's main plant and offices were located in buildings owned by it at 3353 Second Avenue, Sacramento, California. (II-R. 215.)

The meat products processed by the partnership were sold under the name "Made Rite Camellia Brand". Sales were made to grocery stores and other retail outlets in the northern two-thirds of California by driver-salesmen employed by the partnership to cover regularly assigned routes. The driver-salesmen made sales to their customers directly from the trucks. Small quantities of other products, such as cheese, purchased by the partnership from other producers, were also sold by the driver-salesmen. In addition, small amounts of fresh meats were sold directly from the plant. (II-R. 216.)

During the calendar years 1948 through 1954, the net income of the partnership and each partner's share in such income were as follows (II-R. 216):

Year	Partnership Net Income	Dillier	Johnson, Halter, Curnow and Kaelin, each
1948	$244,248.69	$135,693.73	$27,138.74
1949	221,584.00	44,316.80	44,316.80
1950	191,904.00	38,380.80	38,380.80
1951	226,049.46	45,209.89	45,209.89
1952	275,341.90	55,068.38	55,068.38
1953	260,091.05	52,018.21	52,018.21
1954	231,453.96	46,290.79	46,290.79

In March 1954, Johnson had conversations and correspondence with representatives of The Equitable Life Assurance Society regarding the possibility of a sale and lease-back transaction with that company concerning the real estate of the partnership. In July 1954, Equitable rejected the proposal. (II-R. 216.)

Sometime in 1954 or 1955, Johnson developed the idea of incorporating the business conducted by the partnership. He discussed some of the problems involved with various business people with whom the partnership dealt, including a banker, an insurance agent, and the partnership's outside public accountant. In May or June 1955, the partners decided to incorporate the business, utilizing four corporations: Made Rite Manufacturing Company would purchase meats and process them into sausage products; Made Rite Sausage Company would sell the products; Made Rite Investment Company would hold title to the real estate used in the business; Made Rite Transportation Company would hold title to the delivery trucks, refrigerator trucks, and other motor vehicles used in the business. Articles of incorporation for the four Made Rite corporations were executed by the five partners as incorporators and filed; the five partners were designated to act as the first directors of each corpor

At the time of the incorporations, Johnson understood that three additional surtax exemptions would be available if four corporations, rather than a single corporation, were formed to take over the business of the partnership. (II-R. 217.)

According to the minutes of the respective corporations, the partners, in "Offers to Transfer Assets", purported to offer to transfer a certain portion of the partnership assets to one of the corporations, and the corporation purported to accept the offer. The consideration was to be the assumption by the corporation of certain partnership liabilities and the issuance of stock and notes to the partners. The obligation to issue the stock and notes was made subject to the corporation obtaining an appropriate permit from the Commissioner of Corporations of the State of California. (II-R. 226.)

The officers named in the corporate minutes were as follows (II-R. 225):

	Sausage	Manufacturing	Transportation	Investment
President	Curnow	Halter	Kaelin	Johnson
Vice President	Halter	Kaelin	Curnow	Halter
Secretary	Johnson	Johnson	Johnson	Kaelin
Treasurer	Kaelin	Curnow	Halter	Curnow

The Made Rite corporations were authorized to issue $100 par value stock and notes as follows (II-R. 227):

Corporation	Date of Permit	Shares of Common Stock Authorized	Notes Authorized
Sausage	March 15, 1956	200	$ 30,000
Investment	April 12, 1956	1,250	275,000
Manufacturing	April 12, 1956	1,100	300,000
Transportation	April 12, 1956	200	40,000

The authorized stock and the notes of each of the four corporations were issued to the five partners in equal amounts. (II-R. 228.) On the same day, the shareholders and the four corporations executed "Stock Purchase Agreements". (II-R. 228.) These agreements, identical except for the name of the corporation, provided that a stockholder, before disposing of any of his stock in the corporation during his lifetime, was required to offer to sell it first to the corporation and then to the remaining stockholders. These restrictions were not applicable to sales or gifts of the stock to children of the stockholders, but such sales or gifts could be effected only if the stockholder sold or gave to such children an equal percentage of his stock in all four Made Rite corporations. It was further provided that the stock could be bequeathed by will only to certain family members of the stockholder or could be placed in inter vivos testamentary trusts for the benefit of the family members. Otherwise, upon the death of a stockholder, the corporation had the right to purchase the stock owned by the decedent, and the remaining stockholders were required to purchase, pro rata among themselves, any of such stock not purchased by the corporation. (II-R. 226-227.)

Each of the stock purchase agreements further provided that the agreement was "mutual with and reciprocally dependent upon corresponding agreements executed this date between [the five stockholders and each of the other three Made Rite corporations] and that an election, an offer to sell, or any notice given in pursuance of those agreements shall also be considered and construed as exercising the same act under this agreement." (II-R. 227.)

Finally, each stock purchase agreement provided for the termination of the "Articles of Copartnership" dated February 26, 1949. (II-R. 227.)

The business conducted by the four Made Rite corporations in 1956 and thereafter was the same business which the partnership had previously conducted. Each of the five shareholders continued to perform the same duties which he had performed under the partnership. (II-R. 231.) All four corporations used the former office of the partnership as their office. The records for the corporations were all kept at that office and generally by the same employees. The signs on the main plant were limited to "Camellia Brand" and "Made Rite Sausage". The only listing for the business in the telephone directories was made in the name of Sausage. (II-R. 232.) Throughout 1955 and for an undisclosed period thereafter, the only stationery used in the business bore the name Made Rite Sausage Company. (II-R. 222.)

The meat products manufactured or processed by Manufacturing were sold only through Sausage, and all receipts therefrom were deposited in the Sausage bank accounts. In addition, Sausage distributed small amounts of certain products, such as cheese, purchased by the business from others, as the partnership had done previously. (II-R. 231.) The gross sales of Sausage, as shown on its returns for the years 1956 through 1959, were as follows (II-R. 231):

Year	Gross Sales
1956	$6,586,462.06
1957	7,369,466.31
1958	8,284,965.42
1959	7,693,123.90

No inventory was recorded on the books of Sausage. The entire inventory of the business was recorded on the books of Manufacturing, and the dollar amounts of "sales" from Manufacturing to Sausage were determined by calculations made after Sausage had sold the products to customers. These calculations were made by one of two methods: One method was to take the amounts by weight of the various types of products sold by Sausage and apply thereto certain prices per pound or ton for each type; the other method was to apply percentage figures to the dollar amounts of the gross sales of Sausage. (II-R. 231.)

In 1957, Manufacturing applied to the Crocker-Angle National Bank for a line of credit in the amount of $200,000. As a prerequisite, the bank required that Investment, Transportation, and Sausage guarantee repayment of the funds advanced to Manufacturing and that the notes payable by the four Made Rite corporations to the five stockholders be subordinated to the obligation to the bank. The boards of directors of Investment, Transportation, and Sausage authorized such guarantees, and the stockholders agreed to subordinate their notes. The bank granted the line of credit sought. (II-R. 233.)

In 1958, Manufacturing sought to increase its line of credit with the bank to $300,000. The boards of directors of the respective corporations similarly authorized guarantees of the increased amount. (II-R. 23

Title to the plant and the surrounding real property was transferred by the partnership to Investment in 1956 and a first deed of trust was executed to secure the promissory notes issued by Investment to the five stockholders which totalled $275,000. (II-R. 228.) The partnership

transferred to Sausage a warehouse and adjoining realty located at Chico, California, in 1956. (II-R. 228.) At some undisclosed time, two leases, running from Investment to Transportation and to Manufacturing, respectively, were prepared. One of these instruments purported to lease the garage and parking lot adjoining the main plant to Transportation for a five-year term at an annual rate rental of $4,050. The other instrument purported to lease the plant itself to Manufacturing for a similar five-year term, at a total rental of $487,000 for the five years. (II-R. 220.) In 1959 Investment acquired further property which was used by Manufacturing to house certain meat processing operations. (II-R. 233.)

All of the amounts reported as rental income on the returns filed by Investment represented intercompany payments from Manufacturing, Transportation, and Sausage, except for small amounts derived from rental of a parking lot and a few residential units to unrelated parties. (II-R. 231-232.)

In February 1956, the partnership transferred title to 30 motor vehicles to Transportation, including five executive automobiles, one each for Dillier, Curnow, Halter, Johnson, and Kaelin. At an undisclosed time an instrument entitled "Truck Lease Service Agreement" was prepared which purported to lease from Transportation certain motor vehicles to Sausage. (II-R. 220, 223.) All of the amounts reported as rental income on the returns filed by Transportation represented intercompany payments from Sausage, including payments for the five executive automobiles. No rental payments to Transportation for use of the executive automobiles were made by or accrued on the books of Manufacturing or Investment. No vehicles owned by Transportation were rented to outsiders. (II-R. 232.)

At least three labor unions represented various employees of the partnership: The teamsters union represented the driver-salesmen; the butchers' union represented certain meat processing employees; and the packers' union represented other meat processing employees. Beginning at some undisclosed time after the formation of the Made Rite corporations, labor contracts with the teamsters union were signed by Sausage, and those with the butchers' union were signed by Manufacturing. The employees of the partnership belonging to the packers' union became employees of Manufacturing, but neither the packers' union nor the association which had bargained with that union on behalf of the partnership were ever advised of the change of the employer. (II-R. 232.)

During 1954 or 1955, the approximate ages of the partners were as follows: Dillier, 63; Halter, 56; Curnow, 56; Kaelin, 55; and Johnson, 49. (II-R. 215.)

During the years 1956 through 1959, the Made Rite corporations paid the following amounts to the five stockholders as compensation and claimed them as deductions on their respective income tax returns (II-R. 233-234):

1956	Sausage	Manufacturing	Transportation	Investment	Total
Dillier	$ 2,000	0	$23,800	0	$ 25,80
Kaelin	0	$ 25,800	0	0	25,80
Curnow	25,800	0	0	0	25,80
Johnson	0	0	0	$25,800	25,80
Halter	0	25,800	0	0	25,80
Totals	$27,800	$ 51,600	$23,800	$25,800	$129,00

1957	Sausage	Manufacturing	Transportation	Investment	Total
Dillier	$ 6,800	$ 6,800	$ 6,400	$ 4,800	$ 24,800
Kaelin	0	24,800	0	0	24,800
Curnow	24,800	0	0	0	24,800
Johnson	9,520	11,520	1,760	1,760	24,560
Halter	0	24,800	0	0	24,800
Totals	$41,120	$ 67,920	$ 8,160	$ 6,560	$123,760
1958					
Dillier	$ 9,240	$ 18,720	$ 400	0	$ 28,360
Kaelin	7,160	21,200	0	0	28,360
Curnow	28,360	0	0	0	28,360
Johnson	13,560	15,120	160	0	28,840
Halter	3,000	25,360	0	0	28,360
Totals	$61,320	$ 80,400	$ 560	0	$142,280
1959					
Dillier	$ 6,240	$ 18,720	0	0	$ 24,960
Kaelin	4,160	30,300	0	0	34,460
Curnow	29,960	4,750	0	0	34,710
Johnson	10,400	24,310	0	0	34,710
Halter	0	34,960	0	0	34,960
Totals	$50,760	$113,040	0	0	$163,800

The net income (or loss) of the Made Rite corporations for the years 1955 through 1959, as shown on the returns filed for those years, was as follows (II-R. 223, 235):

	1955[4/]	1956	1957	1958	1959
usage	$ 12,740.72	$100,401.42	$57,609.51	$ 37,922.00	$ 73,162.91
nufacturing	112,101.02	39,661.29	(57,757.27)	17,842.62	160,419.10
vestment	21,744.44	18,288.87	55,020.57	54,255.37	31,149.49
ansportation	30,974.40	30,133.25	33,695.23	41,531.81	57,513.89
Totals	$177,560.58	$188,484.83	$88,568.04	$151,551.80	$322,245.39

4/ Period July 18, 1955 through December 31, 1955.

During the period 1955 through 1959, the Made Rite corporations paid dividends as follows (II-R. 235):

	Sausage	Manufacturing	Transportation	Investment
1955	-o-	-o-	-o-	-o-
1956	-o-	$11,000 [1]	-o-	-o-
1957	$ 37,000	-o-	-o-	-o-
1958	25,000	-o-	-o-	-o-
1959	57,078	-o-	-o-	-o-
Totals	$119,578	$11,000	-o-	-o-

[1] This amount represents the payments made by Manufacturing in February 1956, prior to the issuance of the stock.

The Commissioner of Internal Revenue disallowed surtax exemptions to the four Made Rite corporations in his deficiency notices for the taxable years 1956 through 1959 on the ground that the corporations were created, availed of, and operated in order to avoid federal income taxes by securi the benefit of the surtax exemption which they would not otherwise enjoy. (I-R. 11, 13, 78, 80, 145; II-R. 235A.) In his opening statement, counsel for the Commissioner conceded that one surtax exemption should be allowed, either to one of the corporations or apportioned among the four corporations. (II-R. 247; IIA-R. 11-12.)

The Tax Court found that the principal purpose for the organization of the four Made Rite corporations, rather than a single corporation, and the acquisition of all of the stock of the corporations by the partners was to avoid federal income tax by securing the benefit of three additional surtax exemptions which would not otherwise have been available.

(II-R. 237-238.) The court allocated one surtax exemption to Sausage for the taxable years 1956 and 1957. (II-R. 254-255.) 5/

II

Reasonable compensation

On its income tax returns for the taxable years 1956 and 1957, Investment claimed deductions for compensation paid as follows (II-R. 235A):

	1956	1957
Thores Johnson	$25,800.00	$1,760.00
Joseph Dillier	--	4,800.00
Geneva Hayhurst	5,238.00	--
Chester Brewster	2,916.80	--
M. Schoenbacker	55.00	--
Totals	$34,009.80	$6,560.00

Johnson had been in charge of the office and clerical functions, credit collections, advertising and bookkeeping, purchasing of packaging supplies, and labor relations of the partnership. In 1955, he assumed more of the general managerial duties when Dillier took a less active and more advisory role in the business of the partnership. (II-R. 215.) When the business conducted by the partnership was incorporated, the same division of duties among the former partners was maintained. (II-R. 231.)

Johnson devoted some time during 1956 to the affairs of a corporation named Zephyr Heights Subdivision, Inc., at Lake Tahoe, for which he received a salary of $4,800. In September 1956, he had one or more

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5/ The Tax Court also held that the business activities of the partnership had not been taken over by the Made Rite corporations during 1955. Consequently, the gross income and deductions reported by the corporations for that year were reportable by the partnership and the distributable shares of the partners were includible in their individual returns for 1955. (II-R. 235-236, 237.) The partners have not sought review of this holding.

telephone conversations with a real estate brokerage firm in Los Angeles, California, and received a letter from that firm naming a prospective purchaser of the Made Rite plant, but no sale was made to the person named. Prior to or on January 29, 1957, Johnson met with one or more representatives of a company named Arden Milk Company. A letter dated January 29, 1957, written by a representative of Arden stated that (II-R. 235A-236):

> Arden is interested in working out a merager [sic] with the Maid-Rite [sic] Co. and are ready to do so as soon as we get the papers outlining the best exchange of Arden's stock for that of Maid-Rite [sic] plus the lease-back idea, talked about in your meeting.

However, no transaction was consummated with Arden Milk Company. (II-R. 236.)

Dillier had been the general manager of the partnership, but beginning in 1955 he took a less active role in the business and his duties became advisory in nature. (II-R. 215.) This division of duties continue after the business was incorporated. (II-R. 231.)

Geneva Hayhurst had been employed by the partnership in 1941 as a bookkeeper. During 1956, she was the office manager for the four corporations but received compensation only from Investment. Her duties included supervision of the office services for all four corporations and keeping the books for Sausage and Manufacturing. The bulk of her work was concerned with the business of Sausage and only a small portion of her time was devoted to the affairs of Investment. The books of Investment and Transportation were kept by another bookkeeper in the office. Investment paid no other office salaries during the years 1956 through 1959 and it did not claim a deduction for any office expenses on its returns for thos

years. During 1957, 1958, and 1959, Miss Hayhurst received no compensation from Investment. The record does not indicate which of the other Made Rite corporations paid her salary for those years. (II-R. 236.)

Chester Brewster had been the night watchman for the partnership and he continued to perform the same function after the four corporations took over the business. His duties were to guard the main plant building, the title to which was transferred to Investment in 1956, as well as the property belonging to the other Made Rite corporations located on the plant premises, including trucks, title to which was in Transportation, and machinery and inventory, which were listed as belonging to Manufacturing. (II-R. 236-237.)

M. Schoenbacker acted as night watchman for one week during 1956 while Brewster was on vacation. (II-R. 237.)

The amounts paid by Investment during 1956 to Brewster and to Schoenbacker were the only amounts paid by any of the Made Rite corporations for the services of night watchmen during that year. During 1957, 1958, and 1959, the night watchmen employed in the Made Rite businesses received their entire compensation from Manufacturing. (II-R. 237.)

The Commissioner disallowed as unreasonable $32,009.80 of the total $34,009.80 claimed as a deduction by Investment for salaries in 1956. He also disallowed $4,300 of the $6,560 claimed in 1957. (I-R. 11, 13; II-R. 237.)

Transportation claimed as deductions for compensation paid to Dillier in 1956 and 1957 the amounts of $23,800 and $6,400, respectively. (II-R. 233-234.) The Commissioner determined that only $500 in each of these years represented a reasonable allowance for services rendered. (I-R. 78, 80; II-R. 237.)

The Tax Court found that the following amounts represented reasonabl compensation for services rendered to Investment and Transportation (II-R 238):

	Year	Employee	Amount
Investment:	1956	Johnson	$1,760
		Hayhurst	500
		Brewster	1,200
		Schoenbacker	25
	1957	Johnson	1,760
		Dillier	500
Transportation:	1956	Dillier	500
	1957	Dillier	500

SUMMARY OF ARGUMENT

This case presents two questions in the context of a multiple corpor tion scheme. A partnership composed of five men operated a business whic manufactured and sold sausage products, hams, and bacon. It owned its own plant and sales trucks. In 1955, the partners decided to incorporate the business and they utilized four corporations. One corporation took over the manufacturing operation and another handled the sales. The real estate was transferred to a third corporation and the trucks to a fourth corporation. The truck, real estate, and manufacturing corporations are involved in this review.

1. The corporate income tax is composed of a normal tax applicable to all taxable income, and a surtax applicable to taxable income in excess of $25,000. By utilizing four corporations instead of one, the partners, equal shareholders of the stock of all four corporations, obtained the benefit of three additional surtax exemptions. The Tax Court found that the principal purpose for the organization of four corporations, rather than one, was to avoid tax by obtaining the additional surtax exemptions.

On review, we assert that this finding is supported by substantial evidence and is not clearly erroneous. Thores Johnson, the partner who researched the problem of incorporation, understood at the time the corporations were organized that three additional surtax exemptions would be available under the multiple corporation scheme. After incorporation, the four corporations operated the business as a single integrated operation. Sausage, the sales corporation, sold, with few exceptions, only the products manufactured by Manufacturing. Transportation rented all of its trucks to Sausage; Investment, the real estate corporation, rented all of the real estate to Sausage, Manufacturing, and Transportation, except for a parking lot and a few residential units. The corporations all used the same office, and generally the same employees kept their books. The same trade names and signs formerly used by the partnership were used by the corporations. The establishment of the four corporations was not publicized.

However, Johnson testified that obtaining additional surtax exemptions was not the decisive reason for adopting the multiple corporation scheme. He listed a number of factors which he claimed motivated the formation of the four corporations. These factors indicate, at most, only a need for one corporation, not four. The evidence that the partners were aware of the tax advantages of forming multiple corporations and the evidence that the stockholders operated the corporations as a single integrated operation plainly indicate that only one corporation was necessary and that the additional three corporations were formed to avoid tax by obtaining additional surtax exemptions.

2. Two of the corporations, Investment and Transportation, made payments to certain officers and employees during the years 1956 and 1957 which they claimed as deductions for compensation. The Commissioner disallowed them and the Tax Court determined the amount of reasonable compensation paid to these officers and employees and allowed deductions to that extent. The officers and employees involved performed services for more than one of the corporations, but only one paid them. They spent only a part of their working time on the affairs of the corporation who paid them, yet that corporation claimed as deductions the entire amounts paid to them.

The position of these corporations on review seems to be that the deductions are allowable in full since the officers and employees in question performed services for the collective Made Rite enterprise. However, the deduction for business expenses is limited to the ordinary and necessary expenses of the taxpayer. Deductions are personal to the corporate taxpayer and are not transferable or usable by another corporation. The taxpayers contend, and the Tax Court held, that each of the Made Rite corporations has a separate and independent existence. It cannot be said that it was an ordinary and necessary expense of the respective taxpayers to compensate officers and employees for services which they rendered to one or more of the other Made Rite corporations.

ARGUMENT

I

THE TAX COURT CORRECTLY FOUND THAT THE PRINCIPAL PURPOSE FOR THE ORGANIZATION OF THE FOUR MADE RITE CORPORATIONS, RATHER THAN ONE CORPORATION, WAS TO AVOID TAX BY SECURING THE BENEFIT OF THREE ADDITIONAL CORPORATE SURTAX EXEMPTIONS

A. The question of principal purpose is a question of fact; its resolution must be affirmed on review if it is supported by substantial evidence and is not clearly erroneous

The federal corporate income tax consists of two parts; a normal tax is imposed on all taxable income and a surtax is imposed on all taxable income in excess of $25,000. The rates of both the normal tax and the surtax have varied. During the taxable period here in question, 1956 through 1959, the normal tax was 30 percent of taxable income and the surtax was 22 percent of taxable income above $25,000. Section 11, Internal Revenue Code of 1954, Appendix, infra. Since the first $25,000 of corporate taxable income is exempt from the surtax, it is obviously beneficial to arrange to divide taxable income among several corporations and thereby obtain several surtax exemptions. 6/

Section 269 of the Internal Revenue Code of 1954, Appendix, infra, provides the Commissioner with a means of preventing tax avoidance in such situations. That provision states that if any person acquires control of a corporation, "and the principal purpose" for the acquisition

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6/ The Congressional intent in providing surtax exemptions to corporations was to facilitate the creation and expansion of small business. H. Rep. No. 586, 82d Cong., 1st Sess., p. 23 (1951-2 Cum. Bull. 357, 374); S. Rep. No. 781, 82d Cong., 1st Sess., p. 15 (1951-2 Cum. Bull. 458, 469).

is "evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person would not otherwise enjoy," that "deduction, credit, or other allowance shall not be allowed." Section 269 applies to disallow multiple corporate surtax exemptions. Kessmar Construction Co. v. Commissioner, 336 F. 2d 865 (C.A. 9th); Bonneville Locks Towing Co. v. United States, 343 F. 2d 790 (C.A. 9th). See also James Realty Co. v. United States, 280 F. 2d 394 (C.A. 8th). The section applies to disallow items to the acquired corporations as well as to the acquiring person. Commissioner v. British Motor Car Distributors, Ltd., 278 F. 2d 392 (C.A. 9th); Urban Redevelopment Corp. v. Commissioner, 294 F. 2d 328 (C.A. 4th); Treasury Regulations on Income Tax (1954 Code), Section 1.269-3(a), Appendix, infra.

The determination whether the principal purpose for the acquisition of corporate stock is the avoidance of tax is a question of fact to be resolved by the trier of fact. Kessmar Construction Co. v. Commissioner, supra; Bonneville Locks Towing Co. v. United States, supra. To constitute the principal purpose, the purpose to avoid tax must exceed in importance any other purpose. Hawaiian Trust Co. v. United States, 291 F. 2d 761, 765-766 (C.A. 9th). See also, Treasury Regulations on Income Tax (1954 Code), Section 1.269-3(b)(2), Appendix, infra. Thus, the tax avoidance purpose need not constitute the sole purpose, nor must it exceed in importance the sum of all other purposes. It is sufficient to invoke Section 269 if the tax avoidance purpose is more significant than any other purpose.

We agree with the taxpayers (Br. 35-36) that where the trier of fact -- in this case, the Tax Court -- has decided the factual question whether there was present the requisite principal purpose to avoid tax, the only inquiry open to the reviewing court is whether the finding of fact is supported by substantial evidence and is not clearly erroneous. United States v. Gypsum Co., 333 U.S. 364, 395; Kessmar Construction Co. v. Commissioner, supra. The rule applies as well to factual inferences drawn from undisputed basic facts. Commissioner v. Duberstein, 363 U.S. 278.

B. The evidence fully supports the finding of the Tax Court

The partnership composed of Dillier, Curnow, Halter, Johnson, and Kaelin had carried on an integrated business of manufacturing and selling sausage products, and the four Made Rite corporations carried on this same business as an integrated operation. Mr. Johnson, who was the taxpayers' principal witness at the trial, testified that he was aware of the surtax advantages of multiple corporations at the time the corporations were organized, but stated that it was not a decisive reason. Rather, he recited a number of alleged reasons which he claimed had motivated the partners to adopt the multiple corporation scheme. Although some of these alleged reasons were somewhat unclear, the principal ones, as noted by the Tax Court (II-R. 249), were: (1) Problems potentially arising from the death of a stockholder would be reduced; (2) labor problems would be minimized; (3) more accurate accounting figures for each function of the business would be obtained; (4) limited liability would be

obtained for each corporation; (5) the adoption of profit-sharing or incentive plans would be facilitated; (6) unequal cash withdrawals by the partners would be eliminated; and (7) the discounting of secured notes issued to the stockholders could provide funds to pay off certain personal obligations of the stockholders. 7/

The Tax Court analyzed in detail each of the seven alleged reasons listed by Johnson and found them lacking in substance. (II-R. 249-253.) The court concluded its lengthy analysis with the statement (II-R. 253):

> We are convinced, from our study of the record, that the alleged business objectives did not in fact motivate the organization of the multiple corporations. The one purpose of apparent substance was the obtaining of the additional surtax exemptions of which Johnson had cognizance.

Consequently, the Tax Court found that the principal purpose for the organization of the four Made Rite corporations, instead of one corporation, was to avoid federal income tax by obtaining the benefit of three additional surtax exemptions. (II-R. 237-238.)

The taxpayers contend here (Br. 38, 42-48), as they did in the court below (II-R. 247, 249), that each was organized for a valid business purpose and that each was a viable business entity which was actually engage

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7/ For convenience, we list these alleged reasons in the order in which the Tax Court listed and discussed them. (II-R. 249-253.) In our subsequent consideration of them, we will discuss them in the order in which Johnson listed them, but numbering them (e.g., Item 1, Item 2, etc.) as the Tax Court did.

n a substantive business activity. 8/ The record, however, plainly stablishes that the principal purpose for the organization of the four Made Rite corporations, rather than one corporation, was to avoid tax by ecuring the benefit of three additional corporate surtax exemptions.

1. The operation of the corporations

The manner in which the partner-stockholders operated the Made Rite usiness after incorporation belies the need for four corporations. Prior o incorporation, the partnership carried on the meat packing business as single integrated operation. The partnership bought raw meat supplies nd manufactured or processed them into sausage products, ham, and bacon n its own manufacturing plant. It sold its finished products to retail utlets through driver-salesmen operating trucks owned by the partnership n a sales territory which covered the northern two-thirds of California. II-R. 214, 216.)

When the corporations commenced business, they operated a single, ntegrated business enterprise. It was the same business which had been reviously operated as a single enterprise by the partnership. The five hareholders carried out the same responsibilities which they had previously

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/ It should be noted that the Tax Court made no finding that any of the axpayers were not viable corporations. If such were the case, then the ncome reported by the four corporations would be taxable to the viable ne. See Shaw Construction Co. v. Commissioner, 323 F. 2d 316 (C.A. 9th); ldon Homes, Inc. v. Commissioner, 33 T.C. 582. Here, the Tax Court ound that more than one corporation had been formed to avoid tax and in- oked Section 269 to deny to the other three corporations the surtax xemptions. Consequently, the argument and authorities advanced by the axpayers (Br. 40-44) for the proposition that the taxpayers are viable axable entities are irrelevant.

had as partners. (IIA-R. 181-186, 261-263.) There was no change in the products handled, the sales territory covered, or in the personnel used in the business. The overall nature of the business did not change; the partner-stockholders did not want it to change. (IIA-R. 195-196.)

The meat products manufactured or processed by Manufacturing were sold only through Sausage and all sales receipts were deposited in the bank accounts of Sausage. (IIA-R. 194, 196.) Although Sausage was purportedly an independent corporation selling meat products, it sold only the products of Manufacturing, with minor exceptions, and carried no inventory on its books. (II-R. 231; IIA-R. 194.) The entire inventory of the business was recorded on the books of Manufacturing, and "sales" from Manufacturing to Sausage were determined by calculations made after Sausage had sold the products to customers. These calculations were either made on the basis of a certain price per pound or ton of the products sold or on the basis of certain percentages of the dollar amount of the gross sales of Sausage. The price or percentage was set by the stockholders. (II-R. 231; IIA-R. 307-308.)

All of the rental income of Investment was derived from intercompany payments from the other three corporations, except for small amount received from the rental of a parking lot and a few residential units to unrelated parties. (II-R. 231-232.) All of the rental income of Transportation represented intercompany payments from Sausage; Transportation rented none of its vehicles to outsiders. (IIA-R. 194.)

The Made Rite corporations used the same office which the partnership had used. The records for the four corporations were all kept at that office and generally by the same employees. (II-R. 232.) The signs on the main plant and the office building were limited to "Camellia Brand" and "Made Rite Sausage". (IIA-R. 366-367.) The only listing for the business in the telephone directories was made in the name of Sausage. (Stip. par. 14, I-R. 199.) During 1955 and for an undisclosed period thereafter, stationery bearing the name Made Rite Sausage Company was used to transact business on behalf of all four Made Rite corporations. (II-R. 222.) No particular effort was made to tell customers or suppliers that four corporations were being used. (IIA-R. 203-204.)

In addition to the foregoing evidence that the stockholders operated the business in a manner requiring only one corporation, they also executed "Stock Purchase Agreements" which were designed to keep the business of the four corporations integrated by keeping the ownership of the stock in the stockholders and their children. Each agreement required a stockholder, before disposing of any of his stock in the corporation during his lifetime, to offer to sell it first to the corporation and then to the remaining stockholders. This requirement did not apply to sales or gifts of stock to children of the stockholders, but such dispositions could be effected only if the stockholders sold or gave to the child in question an equal percentage of his stock in all four Made Rite corporations. Moreover, the stock could only be disposed of by will to, or placed in an inter vivos trust for the benefit of, certain family members of the stockholder. Otherwise upon the death of a

stockholder, the corporation had the right to purchase the stock owned by the decedent and the surviving stockholders were required to purchase equally among themselves any stock not bought by the corporation. (II-R. 226-227.)

Each stock purchase agreement further provided that it was mutual with and reciprocally dependent upon the corresponding agreements executed between the five stockholders and each of the other three Made Rite corporations and that "an election, an offer to sell, or any notice given in pursuance of those agreements shall also be considered and construed as exercising the same act under this agreement." (II-R. 227.)

Finally, the business had an average net income in excess of $200,000 while operated by the partnership. Its earnings were as follows (II-R. 216):

Year	Partnership Net Income
1948	$244,248.69
1949	221,584.00
1950	191,904.00
1951	226,049.46
1952	275,341.90
1953	260,091.05
1954	231,453.96

As can be seen, there existed the likelihood that the income of a corporation or corporations which might be formed to operate the business might exceed a single surtax exemption of $25,000.

The income of the four corporations consisted almost entirely of intercompany payments, whose amounts were controllable by the stockholders and their net income record indicates that they receive for the most part

full benefit of the surtax exemptions. The net income (or loss) of the corporations was as follows (II-R. 235):

	1956	1957	1958	1959
Sausage	$100,401.42	$57,609.51	$ 37,922.00	$ 73,162.91
Manufacturing	39,661.29	(57,757.27)	17,842.62	160,419.10
Investment	18,288.87	55,020.57	54,255.37	31,149.49
Transportation	30,133.25	33,695.23	41,531.81	57,513.89
Totals	$188,484.83	$88,568.04	$151,551.80	$322,245.39

2. The testimony of Thores Johnson

Thores Johnson, the only partner who testified, stated that at the time the four Made Rite corporations were formed, he understood that the business would get additional surtax exemptions if four corporations were formed rather than one. However, he also stated that extra surtax exemptions were not a decisive purpose in the adoption of the multiple corporation scheme. (IIA-R. 201-202.) He testified that he had asked William Himmelman, Jr., the partnership's outside accountant (IIA-R. 269), about the extra exemptions (IIA-R. 243); Himmelman denied telling Johnson that he could get additional exemptions (IIA-R. 321-322). Johnson also recited a number of alleged business reasons which he claimed motivated the organization of multiple corporations. (IIA-R. 29-38.)

The taxpayers contend (Br. 38, 44) that the Tax Court incorrectly interpreted Johnson's testimony in stating that there were seven principal reasons for the adoption of the four corporations (II-R. 249) and assert that there was in fact only one substantial business purpose, i.e., to provide for financial flexibility in the event of the death or retirement of a partner. This allegation is a curious one since it would seem

that the Tax Court erred, if it be that, in favor of the taxpayers. The court exhaustively analyzed a number of alleged reasons, including the ones underlying the purpose which the taxpayers now say was the real one providing for problems potentially arising from the death of a sharehold (Item 1) and obtaining funds by discounting secured notes issued by the corporations (Item 7) -- and ones which the taxpayers presently label as "merely incidental" (Br. 44). The taxpayers also suggest that the Tax Court, in considering the potential problems arising upon the death of a stockholder, entirely ignored the problem of a partner's retiring. (Br. 37-38.) However, the court did consider the basic issue when it considered the problem of providing funds to the stockholders for the satisfaction of their personal obligations by the discounting of secured notes of the corporations (Item 7) and the possible sale of the real estate and trucks to provide for the survivors upon the death of a partner (Item 1). Moreover, Johnson placed no emphasis in his testimony on retirement and its possible problems to the business and the partners (IIA-R. 29, 237-238), but discussed only the ramifications of a partner's death (IIA-R. 29-30).

In any event, an examination of the testimony given by Johnson indicates that he listed a number of alleged business reasons for the organization of the four corporations (IIA-R. 29-47), and that all of them were on his mind in the spring of 1955 (IIA-R. 47), when the decision was made to organize the Made Rite corporations (IIA-R. 48). He testified that the partners realized in 1954 that there were difficulties with the partnership form of organization which they were using They were having trouble paying out of the earnings of the business the

otes which they owed to Dillier for the purchase of their interests in
ne partnership and they had had problems with the survivors of partners
nen a partner died. (IIA-R. 23.) He testified that he had had an in-
urance man investigate his personal estate planning problems with the
artnership that year. (IIA-R. 25.) Johnson stated that the partners
iscussed the problem among themselves but failed to reach a solution.
e said that he then searched for a solution: he talked to other business-
en, both those with general business experience and those in the industry;
e discussed the problem with the partnership's banker and accountant;
nd he read material regarding it. (IIA-R. 24-25.) He stated that he
ad come to the tentative conclusion in 1954 that the best solution was
o incorporate the business, utilizing four corporations. (IIA-R. 28-29.)
n the spring of 1955, he discussed the plan with Malland L. Madland, an
fficer in the bank to which the partnership was obligated (IIA-R. 264-
5), who assured him that it was an excellent plan (IIA-R. 28-29, 264-265).

(a) Death of a partner-stockholder (Item 1)

At this point, counsel for the taxpayers asked Johnson (IIA-R. 29)
ill you give us some of these reasons that led you to the conclusion
the four corporations?" Johnson replied (IIA-R. 29) "Well, one thing
s the advancing age of the partners, with death and retirement as fac-
rs." He then discussed the potential problems resulting from the death
a partner. Under the multiple corporation scheme, it was thought that
e survivors might be persuaded to retain the stock of the corporations
lding the real estate and trucks since they would yield a fixed income.
that circumstance, the remaining stockholders would have to raise cash

only to acquire the decedent's stock in the sales and manufacturing corporations. (IIA-R. 29-30.)

As the Tax Court pointed out (II-R. 249-250), this is no explanation for the use of more than one corporation. The purported intention to hold the real estate and trucks for the purpose of providing the survivor with a fixed income is inconsistent with the sale and leaseback of the trucks in 1962 (IIA-R. 30-31) and the efforts to do the same thing with the real estate (IIA-R. 26-28, 189-190). 9/ Moreover, the statement that the stock of the real estate and truck corporations would be attractive to the survivors because those corporations would have a "fixed income" (IIA-R. 30) is curious since the trucks provided no income except through their use in the meat packing business (IIA-R. 194), which Johnson at one point termed "speculative" (IIA-R. 39), and the real estate did not provide a significant amount of outside income (IIA-R. 195). Neither Investment nor Transportation paid dividends during the taxable period here in question. (II-R. 235.)

If the survivors did not desire to retain their stock in these two corporations, Johnson testified that their assets could be sold to raise the money necessary to pay the survivors. (IIA-R. 30.) However, he did not explain why a single corporation could not just as readily sell the real estate or trucks to raise the needed cash as multiple corporations.

9/ The taxpayers make several references (Br. 38-39, 46, 48) to an alleged sale of the real estate in 1964. There is no evidence in the record of such a sale. Similarly, the taxpayers give no record reference for several statements regarding the alleged value of the assets of the taxpayers. (Br. 38, 42-43.)

brief (p. 39), the taxpayers suggest that a single corporation would have been able to take advantage of the tax-free liquidation provisions of Section 337 of the Internal Revenue Code of 1954, Appendix, infra, while a separate real estate or truck corporation could. Section 337 allows a corporation, upon the adoption of a plan of complete liquidation, to sell its assets and liquidate without recognizing gain on the sale of its assets. The stockholders, of course, recognize gain since the liquidation is treated as full payment in exchange of their stock. Section 331(a), Internal Revenue Code of 1954 (26 U.S.C. 1958 ed., Sec. 331). Even if the taxpayers read Section 337 correctly, [10] their intention is of no weight here since there is no indication in the record that any of the partners were motivated to utilize multiple corporations for this reason. Moreover, if the partners actually intended to sell the real estate or the trucks, they could have avoided the considerable expense of organizing and maintaining two corporate organizations and any corporate tax on the sale of the assets by retaining those assets for sale by the partnership. In any event, the existence of Section 337 has no effect on Manufacturing, since there is no suggestion in the record that the partners considered the possible sale of the packing plant and equipment as a reason for organizing it.

(b) Security

Counsel for the taxpayers next asked Johnson (IIA-R. 32) "Did you have any other reasons that led you to this conclusion of four corporations that you talked over with your banker in the early part of 1955?"

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[10] There are certain limitations on the application of Section 337.

Johnson replied (IIA-R. 32) "We had the problem of security," and he went on to say that the partners, except for Dillier, had no assets apart from the business and that the industry was undergoing considerable change due to automation which required additional capital (IIA-R. 32-33). This apparently referred to the liability problem (Item 4) about which more will be said (pp. 37-38, infra).

(c) Accounting problem (Item 3)

Johnson was then asked (IIA-R. 33) "Were there other reasons that motivated you to form four corporations?" He replied (IIA-R. 33) "Yes, the accounting problem." He stated that under the partnership organization, costs were allocated among the various operations of the business, but that a partner heading one of the operations which produced a poor record would be inclined to say that it was the result of bookkeeping entries and did not reflect the true results of his department. He said that multiple corporations aided this problem because they were separate entities with separate bookkeeping. The charges were direct expenses of the corporations and there were not arbitrary charges between departments. (IIA-R. 33-34.)

However, as the Tax Court noted (II-R. 251), proper allocation of income and expenses could have been attained by a divisional accounting system. Moreover, it does not appear that the allocation between the corporations was made with any attempt at precision. For one thing, rental payments for the five executive automobiles were all accrued against Sausage (Supp. Stip. par. 91, I-R. 206), although some of the five stockholders were purportedly rendering services primarily to other corporations (II-R. 225, 233-234).

Moreover, under the multiple corporation scheme adopted, accounts ld still involve considerable unreality since the stockholders fixed rent which Investment charged to other corporations for the use of real estate and the rent which Transportation charged Sausage for the i of the trucks. (IIA-R. 195-196.) The sales of Manufacturing were ed on the sales of Sausage. (IIA-R. 307-308.) If the sales of sage, for example, were poor, the stockholder-officer primarily con- ned with its operation could well shrug it off with the comment that large an amount had been paid to Manufacturing for making or pro- sing the products, just as was done under the partnership organization. A-R. 33.)

(d) Discounting notes (Item 7)

Counsel for the taxpayer next asked Johnson (IIA-R. 34) "* * * any of the partners or prior partners have any marital problems?" nson stated that one of the partners had had a financial problem in ing a settlement when he divorced his wife. (IIA-R. 34-36.) He went o say that their banker had indicated that the bank would advance ls on the corporate notes which were secured by the real estate and such funds could be used by the partners to discharge their obliga- to Dillier and by the one partner to satisfy his marital obligations. -R. 36-37.) On brief, the taxpayers state that this reason is part he major business reason which motivated the formation of multiple orations, i.e., financial flexibility. (Pp. 38, 44.)

However, the record contains no indication that the stockholders ever discounted the notes secured by the real estate (II-R. 228) which they received from Investment. Moreover, as the Tax Court pointed out (II-R. 252), the alleged reason provides no explanation why it was necessary to place the real estate in a separate corporation. If the partners had utilized a single corporation, presumably they would have conveyed the real estate to it in return for stock and for notes secured by the real estate, and they could then have discounted such notes with a bank to obtain the funds necessary to satisfy their personal obligations.

(e) Unequal cash withdrawals (Item 6)

Counsel for the taxpayer then asked (IIA-R. 37) "Had there ever been any problem of unequal drawings of partners?" Johnson replied that there had been continual conflict among the partners since they drew on partnership funds to pay their taxes and some of them owed different amounts of taxes. He said that the use of multiple corporations left each partner's tax problem directly to him; and dividends or other money distributed by the corporations would be in proportion to his interest and not in proportion to his taxes. (IIA-R. 38.) Again one wonders, as the Tax Court did (II-R. 252), why the same result could not have been achieved by a single corporation. The stock and notes of the four corporations were issued to the partners in equal amounts (II-R. 228); they consequently received equal dividend payments just as though they owned equal shares in a single corporation. On brief, the taxpayers imply that the unequal cash withdrawal problem was solved by putting the partners on fixed salaries. (P. 48.) Nevertheless, the question still goes unanswered why this result would not have been achieved by the use of one corporation.

(f) Limited liability (Item 4)

Johnson also testified that the partnership was meeting increasingly ere competition and that several firms in the industry had gone out of iness. (IIA-R. 38-40.) He stated that multiple corporations would it the liability of each corporation to the assets employed and, in event that competition got so severe that the manufacturing plant ld not be operated at a profit, they could close it up and purchase plies for the sales corporation from other manufacturers and processors. A-R. 39-41.)

Nevertheless, as the Tax Court noted (II-R. 251), when Manufacturing ght sizable lines of credit from a bank in 1957 and 1958, the other ee Made Rite corporations guaranteed repayment of the funds to be anced by the bank and the five stockholders subordinated the notes y personally held against the corporations to the obligations to the k. (Supp. Stip. pars. 53-54, I-R. 202-203; IIA-R. 196-197.) Thus, end result was the same as if a single corporation had been used.

With respect to the comment that the partners had limited the liability the business to the general public (Br. 47), it should be noted that the tners did not represent themselves to their customers as four separate porations and they made no formal announcement to suppliers that they e now dealing with Manufacturing (IIA-R. 203-204). Johnson testified t he had no way to be certain that suppliers knew of the change except t (IIA-R. 204) "when people would call whom we were dealing with we ld assure them that the same people were responsible so that they would tinue to supply us with meat, but some of them were aware that there

were other corporations." (Emphasis added.) He testified that some were aware that there were other corporations since there was information on file with the Credit Managers Association and a notice had been published in the newspapers. (IIA-R. 204.) However, there were no signs on the plant indicating that Manufacturing was operating the plant; no signs on the garage indicating that Transportation was using the garage. (IIA-R. 366.)

(g) Labor problem (Item 2)

Counsel for the taxpayer next asked (IIA-R. 41) "Did you feel the four corporations would have any effect on labor prior to '55?" The substance of Johnson's answer was that it was thought that if the employees of either the manufacturing corporation or the sales corporation went on strike, the other corporation could continue to operate, since its employees would be members of different unions. (IIA-R. 41-42.) However, Johnson testified further that the Made Rite business had never had a strike of any consequence; in the last thirty years, they had had only a few days lost because of strikes. (IIA-R. 241, 242.) He also stated (IIA-R. 241-242) that when there had been a strike by the members of the teamsters union (who worked for Sausage (IIA-R. 41)), their picket line had been honored by the members of the butchers' union (who worked for Manufacturing (IIA-R. 43)). Johnson also testified that the employee of the partnership belonging to the packers' union became employees of Manufacturing, but that neither the packers' union nor the association which had bargained with that union on behalf of the partnership were ever advised of the change of employer. (IIA-R. 187-188.)

This testimony was duly noted by the Tax Court. (II-R. 250.)

(h) Profit-sharing plans (Item 5)

Finally, counsel for the taxpayers asked whether Johnson had ever ussed pension or profit-sharing plans. (IIA-R. 46.) Johnson said the partners had hoped that with the sales and manufacturing func- s in separate organizations, they could set up profit-sharing incen- plans which would give junior executives incentive and would allow to share in their results. (IIA-R. 46.) The Tax Court noted that argument was without foundation in the record. (II-R. 251-252.) e is no evidence that the corporations ever adopted any such plan or ously considered doing so. (II-R. 252.) Again, Johnson offered no on why multiple corporations were necessary to achieve this purpose.

Finally, the taxpayers assert that their action in voluntarily ng up several surtax exemptions is inconsistent with the finding their principal purpose in organizing the corporations was to d tax by securing additional surtax exemptions. (Br. 48.) They t to the fact that Sausage elected to report its income for 1958 thereafter was a small business corporation under Sections 1371-1377 ne Internal Revenue Code of 1954 (26 U.S.C. 1958 ed., Secs. 1371-1377), only referred to as Subchapter S. (II-R. 214, 253.) This provision ides, in general, for taxing the income of an electing corporation ctly to its stockholders. Since there is no tax on the corporation, e is no surtax exemption.

However, the election made by Sausage to report income under Subchapter S is not inconsistent with the finding of the Tax Court. In the first place, Subchapter S was not added to the Code until 1958 (Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606, Sec. 64(a)), several years after the partners made the decision to organize four corporations in the spring of 1955. (IIA-R. 48.) They claimed the benefit of four surtax exemptions for part of 1955 and for 1956 and 1957. Moreover, considerable benefit was obtained from the surtax exemptions of the taxpayers after Sausage elected to report under Subchapter S. In 1958 and 1959, Sausage had a net income of $37,922 and $73,162.91, respectively, and it paid dividends in those years which amounted to $25,000 and $57,07 The taxpayers paid no dividends during those years. (II-R. 235.) Thus, by adopting Subchapter S, it was possible to make all dividend payments from Sausage without reduction by corporate taxes, while retaining the benefit of the surtax exemptions of the other three corporations.

The references (Br. 48) made to the loss of surtax exemptions upon the dissolution of Investment and Transportation are also unconvincing. Transportation was liquidated in 1962 (II-R. 237); on brief, the taxpayer state that Investment was dissolved in 1964 (Br. 48). These events took place a number of years after the corporations were formed; these corporations claimed the benefit of surtax exemptions throughout the period here in question.

In summary, there was evidence before the Tax Court that the partners understood that three additional surtax exemptions would be obtained

the organization of four corporations rather than one. While there s also testimony concerning a number of business reasons which were aimed to have motivated the organization of four corporations, the fore- ing analysis indicates that they were lacking in substance. At most, ey support the organization of one corporation. There was also evi- nce that the stockholders operated the Made Rite business after incor- ration in a manner requiring only one corporation. In essence, the idence, we submit, indicates reasons for forming one corporation, but ttle reason for organizing four -- except the awareness that three addi- onal surtax exemptions would be available. In this light, the finding the Tax Court -- which heard the testimony and assessed the credibility the witnesses -- that the principal purpose for organizing the tax- vers was to obtain three additional surtax exemptions is clearly sup- ted by substantial evidence and is plainly correct. Kessmar Construc- n Co. v. Commissioner, 336 F. 2d 865 (C.A. 9th); Bonneville Locks ring Co., v. United States, 343 F. 2d 790 (C.A. 9th).

II

THE TAX COURT CORRECTLY DETERMINED THE AMOUNTS OF DEDUCTIONS FOR COMPENSATION PAID TO CERTAIN OFFICERS AND EMPLOYEES OF INVESTMENT AND TRANSPORTATION

Under Section 162(a) of the Internal Revenue Code of 1954, Appendix, infra, a taxpayer is allowed as a deduction all the "ordinary and necessary expenses paid or accrued during the taxable year in carrying on any trade or business," including a reasonable allowance for salaries or other compensation for personal services actually rendered. Three factors must be present before a payment may be deducted as a salary expense under this provision: (1) the payment is in fact compensation; (2) the recipient has actually rendered personal services; and (3) the amount is reasonable when measured by the amount and quality of the services performed with respect to the business of the particular taxpayer. Doernbecher Mfg. Co. v. Commissioner, 95 F. 2d 296, 297 (C.A. 9th); 4 Mertens, Law of Federal Income Taxation, Section 25.61. The question of reasonableness is a question of fact. Hoffman Radio Corp. v. Commissioner, 177 F. 2d 264 (C.A. 9th); Doernbecher Mfg. Co. v. Commissioner, supra.

In the instant case, Investment and Transportation claimed as deductions on their returns for 1956 and 1957 amounts paid to Johnson and Dillier and to certain employees. (II-R. 235A.) The Commissioner disallowed a portion of these claimed deductions as unreasonable. (I-R. 11, 13, 78, 80.) The Tax Court made an exhaustive review of the evidence (II-R. 255-260) and determined the amounts which represented

reasonable compensation to these officers and employees for the services which they rendered to the payor in question (II-R. 238). One common thread runs throughout its discussion of the evidence; the officers and employees in question performed duties for several of the Made Rite corporations, they were paid by one corporation, yet that corporation was claiming the entire amounts paid as deductions for compensation for services rendered to it. (II-R. 255-260.)

Investment and Transportation present no discussion of their contention that the Tax Court erred in resolving the question for reasonable compensation. They merely quote from the opinion in Fine Realty, Inc. v. United States, 209 F. Supp. 286, 290 (Minn.), and submit that the compensation paid to the officers and employees in question was "fair and reasonable." (Br. 49-50.) Their position seems to be that it is irrelevant that Investment and Transportation paid salaries in excess of the value of the services rendered to them since these officers and employees performed some services for the collective Made Rite enterprise.

This argument ignores the statute. To be deductible under Section 162, the payment must be an "ordinary and necessary expense" of the taxpayer. Payments which Investment made for services rendered to the other Made Rite corporations are not an "ordinary and necessary expense" of its operations.

Deductions are a matter of legislative grace and a corporate taxpayer has the burden of clearly showing its right to the deduction. Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593; ABC Brewing

Corp. v. Commissioner, 224 F. 2d 483, 490 (C.A. 9th). Deductions are also personal to the corporate taxpayer and "are not transferable to or usable by another." New Colonial Co. v. Helvering, 292 U.S. 435, 440; E. & J. Gallo Winery v. Commissioner, 227 F. 2d 699, 705 (C.A. 9th). See also, Interstate Transit Lines v. Commissioner, supra.

In this case, taxpayers contend that each of the four corporations was a separate viable entity. (Br. 40-44.) Indeed, the Commissioner and the Tax Court did not consider the Made Rite corporations to be shams but in fact confirmed their separate and independent existence by invoking Section 269 to deny the surtax exemptions. See footnote 8, supra.

The Tax Court analyzed in detail (II-R. 255-260) the evidence concerning the services (or lack of services) which the officers and employe in question rendered to Investment and Transportation -- Johnson (IIA-R. 162, 169-170, 179, 180, 184-185, 197-201, 247), Dillier (IIA-R. 174-176, 184, 185-186, 191-193, 365), Geneva Hayhurst (IIA-R. 162-163, 365, 369-370), Chester Brewster (IIA-R. 163, 166, 170, 179-180, 244-245), and M. Schoenbacker (IIA-R. 169, 170, 180) -- and determined the amounts of reasonable compensation paid to them (II-R. 235A-237, 238). On review, these findings of the Tax Court must be sustained if they are supported by substantial evidence and are not clearly erroneous. United States v. Gypsum Co., 333 U.S. 364, 395.

Investment and Transportation apparently concede that the findings of reasonable compensation paid to the officers and employees in questio are correct since they present no argument to show in what respect these

mounts are clearly wrong. (Br. 49-50.) They had the burden of showing rror on review; having failed to argue the point, they must be deemed o have waived it. Kimball Laundry Co. v. United States, 166 F. 2d 856, 59 (C.A. 9th). Consequently, we present no discussion of the evidence ut stand on the findings and extensive analysis of the Tax Court.

CONCLUSION

For the foregoing reasons, the decisions of the Tax Court should be ffirmed.

Respectfully submitted,

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OVEMBER, 1965.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I ave examined Rules 18 and 19 of the United States Court of Appeals for ne Ninth Circuit, and that, in my opinion, the foregoing brief is in full ompliance with those rules.

_____
J. EDWARD SHILLINGBURG
Attorney

ted this _____ day of November, 1965.

APPENDIX

Internal Revenue Code of 1954:

SEC. 11. TAX IMPOSED.

(a) Corporations in General.--A tax is hereby imposed for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under subsection (b) and a surtax computed under subsection (c).

(b) Normal Tax.--

(1) [as amended by the Tax Rate Extension Act of 1958, P.L. 85-475, 72 Stat. 259, Sec. 2] Taxable years beginning before July 1, 1959.--In the case of a taxable year beginning before July 1, 1959, the normal tax is equal to 30 percent of the taxable income.

* * *

(c) Surtax.--The surtax is equal to 22 percent of the amount by which the taxable income (computed without regard to the deduction, if any, provided in section 242 for partially tax-exempt interest) exceeds $25,000.

* * *

(26 U.S.C. 1958 ed., Sec. 11.)

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

* * *

(26 U.S.C. 1958 ed., Sec. 162.)

SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INCOME TAX.

(a) In General.--If--

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

* * *

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

* * *

(26 U.S.C. 1958 ed., Sec. 269.)

SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) General Rule.--If--

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

* * *

(c) Limitations.--

(1) Collapsible corporations and liquidations to which section 333 applies.--This section shall not apply to any sale or exchange--

(A) made by a collapsible corporation (as defined in section 341(b)), or

* * *

(26 U.S.C. 1958 ed., Sec. 337.)

SEC. 341. COLLAPSIBLE CORPORATIONS.

(a) Treatment of Gain to Shareholders.--Gain from--

(1) the sale or exchange of stock of a collapsible corporation,

(2) a distribution in partial or complete liquidation of a collapsible corporation, which distribution is treated under this part as in part or full payment in exchange for stock, and

(3) a distribution made by a collapsible corporation which, under section 301 (c) (3) (A), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property,

to the extent that it would be considered (but for the provisions of this section) as gain from the sale or exchange of a capital asset held for more than 6 months shall, except as provided in subsection (d), be considered as gain from the sale or exchange of property which is not a capital asset.

(b) Definitions.--

(1) Collapsible corporation.--For purposes of this section, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in paragraph (3), or for the holding of stock in a corporation so formed or availed of, with a view to--

(A) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and

(B) the realization by such shareholders of gain attributable to such property.

(2) Production or purchase of property.--For purposes of paragraph (1), a corporation shall be deemed to have manufactured, constructed, produced, or purchased property, if--

* * *

(B) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property, or

* * *

(3) Section 341 assets.--For purposes of this section, the term "section 341 assets" means property held for a period of less than 3 years which is--

* * *

(D) property described in section 1231 (b) (without regard to any holding period therein provided), except such property which is or has been used in connection with the namufacture, construction, production, or sale of property described in subparagraph (A) or (B).

In determining whether the 3-year holding period specified in this paragraph has been satisfied, section 1223 shall apply, but no such period shall be deemed to begin before the completion of the manufacture, construction, production, or purchase.

* * *

(26 U.S.C. 1958 ed., Sec. 341.)

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

* * *

(b) Definition of Property Used in the Trade or Business.--For purposes of this section--

(1) General rule.--The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not--

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in paragraph (3) of section 1221.

* * *

(26 U.S.C. 1958 ed., Sec. 1231.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.269-3 Instances in which section 269(a) disallows a deduction, credit, or other allowance.

(a) Instances of disallowance. Section 269 specifies two instances in which a deduction, credit, or other allowance is to be disallowed. These instances, described in paragraphs (1) and (2) of section 269(a), are those in which--

(1) Any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

* * *

In either instance the principal purpose for which the acquisition was made must have been the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or persons, or corporation, would not otherwise enjoy. If this requirement is satisfied, it is immaterial by what method or by what conjunction of events the benefit was sought. Thus, an acquiring person or corporation can secure the benefit of a deduction, credit, or other allowance within the meaning of Section 269 even though it is the acquired corporation that is entitled to such deduction, credit, or other allowance in the determination of its tax. If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. This does not mean that only those acquisitions fall within the provisions of section 269 which would not have been made if the evasion or avoidance purpose was not present. The determination of the purpose for which an acquisition was made requires a scrutiny of the entire circumstances in which the transaction or course of conduct occurre in connection with the tax result claimed to arise therefrom. For the presumption of a principal purpose of tax evasion or avoidance see section 269(c) and § 1.269-5.

(b) Acquisition of control; transactions indicative of purpose to evade or avoid tax. If the requisite acquisition of control within the meaning of paragraph (1) of section 269(a) exists, the transactions set forth in the following subparagraphs are among those which, in the absence of additional evidence to the contrary, ordinarily are indicative that the principal purpose for acquiring control was evasion or avoidance of Federal income tax:

* * *

(2) A person or persons organize two or more corporations instead of a single corporation in order to secure the benefit of multiple surtax exemptions (see section 11(c)) or multiple minimum accumulated earnings credits (see section 535(c)(2) and (3)).

* * *

(26 C.F.R., § 1.269-3.)

§ 1.337-1 General.

* * * Sales or exchanges made by a collapsible corporation (as defined in section 341(b)) are excluded from the operation of section 337 by section 337(c). Accordingly, section 337 does not apply to any sale or exchange of property whenever the distribution of such property in partial or complete liquidation to the shareholders in lieu of such sale or exchange would have resulted in the taxation of the gain from such distribution in the manner provided in section 341(a) as to any shareholder or would have resulted in the taxation of the gain in such manner, but for the application of section 341(d). * * *

(26 C.F.R., § 1.337-1.)